

The prime virtue of a market-based approach is that it will allow the Commission to address three basic transitional issues before bringing access rates down to economic cost: (1) replacing the implicit universal service subsidies in the system with explicit ones; (2) removing any overallocation of costs from the interstate jurisdiction; and (3) assessing the extent (if any) to which these reforms might inappropriately prevent ILEC recovery of stranded costs and designing a mechanism to allow the recovery of any such costs in a competitively neutral manner. With regard to "stranded costs," we believe it useful and appropriate for the Commission to distinguish between ILEC investments incurred prior to a fixed date (e.g., the date of enactment of the 1996 Act, or the date of the Commission's access charge reform decision) and any costs incurred after that date (See NPRM, ¶ 255). Ideally, the Commission would establish permanent rules to assure appropriate recovery of the latter on a going-forward basis. As for investments left "stranded" as a result of the change in regulatory regimes, the Commission should undertake to develop some basic accounting rules to determine the extent (if any) to which these costs exist, and to establish a competitively neutral recovery mechanism that would create the least ongoing distortion of purchase and investment decisions in competitive markets to collect the funds necessary to reimburse the ILECs.⁷

At this time, we do not believe it is possible to determine whether such "stranded costs" will exist, or if so, what their magnitude might be. Any such determination will depend, in part, on the policies chosen by the Commission in this proceeding and in its universal service reform. The risk of stranded costs will be greater if the Commission chooses a prescriptive approach to access reform that results in the immediate reduction of access prices to economic costs, but

⁷Structuring a recovery mechanism as a charge that varies with usage is likely to distort price signals. To avoid such distortion, recovery should not be tied to usage.

even if the Commission adopts such policies, we do not believe that ILECs have established at this time that they would necessarily incur such stranded costs, or the magnitude of any such costs that might exist. If the Commission chooses to rely in significant part on a market-based approach to access reform, the uncertainty is greater still, since even if there are certain costs that might otherwise be stranded, ILECs may well have an opportunity to recover these costs. In any approach to access reform and universal service reform, consideration of stranded cost claims would also need to resolve a variety of questions, including the proper accounting of universal service support revenues and the relevance of revenue opportunities in other markets, such as that offered by the ability to offer in-region, inter-LATA services.

Given the advent of competition in a market previously regulated as a natural monopoly, it seems likely that at least some ILECs will claim that they have been denied an opportunity to recover their stranded costs. Again, the Department takes no position as to whether the current regulatory environment will in fact leave the ILECs with either an inappropriate under-recovery or over-recovery of any such costs. Nonetheless, given the likelihood that the Commission will face such claims once competition begins to develop (or once access rates are prescribed to reflect economic cost), the Department recommends that the Commission initiate a proceeding, possibly in cooperation with the States -- to ascertain the basic principles governing how the Commission will evaluate such claims. This proceeding would seek to determine questions that would arise in any stranded cost calculation such as whether the ILECs' opportunities to provide long distance services should be considered in evaluating opportunities for cost recovery. Similarly, this proceeding could determine what competitively neutral mechanisms could be employed to raise any revenue necessary to allow the ILECs to recover such costs. By addressing these and other such questions in advance of the Commission's actual consideration

of any claim that an ILEC has been denied an opportunity to recover its legitimately incurred costs, the Commission will be best prepared to address those issues once any such claim is made and is presented to the Commission.

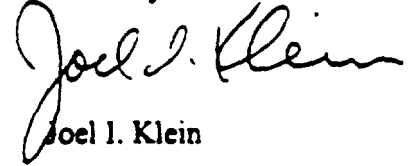
In sum, the Department reaffirms the commitment we made in our filing in the *Local Competition* proceeding to pricing at economic cost as a necessary precondition to full and effective competition in all telecommunications markets. We recognize, however, that the Commission first needs to undertake a series of transitional measures before it will be in a position to prescribe access charges to cost. Indeed, as the Commission undertakes separation reform and institutes a comprehensive system of explicit universal service subsidies, it will be able to reduce access charges to account for the system's present provision of implicit subsidies. Thus, at the proper time, the Commission can prescribe access rates to economic cost and will be prepared to face any claims that the ILECs are saddled with any remaining obligations to serve areas below cost or have been left with any stranded costs. Of course, to the extent that competition has developed in earnest, at least in certain areas, this prescription may be far more limited than one undertaken at this point in time.

VI. CONCLUSION

The Commission's access charge proceeding offers an opportunity to take a crucial step in the transition from a regulated to a competitive telecommunications marketplace. By rationalizing the current access charge rate structure, replacing implicit subsidies with explicit ones, and undertaking the transitional measures necessary to ensure that access prices reflect economic cost of access services, the Commission can help make possible the goals of the

Act. As a result of these changes, consumers will increasingly realize the benefits that competition will bring: enhanced and increased services at better prices.

Sincerely,

A handwritten signature in cursive script, reading "Joel I. Klein". The signature is written in dark ink and is positioned above the printed name.

Joel I. Klein

cc: Commissioner James H. Quello
Commissioner Rachelle B. Chong
Commissioner Susan Ness